

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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subject:

This Chief Counsel Advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Company =

LLC =

M =

State =

Services =

Op Ag =

PMTA : 02030

JVA =

TL =

MA =

Agreements =

TSA =

ESA =

C Ag =

P-Cs =

non-P-Cs =

\$A =

\$C =

\$D =

\$E =

a% =

b% =

c% =

X =

Y =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

ISSUE

Whether, under §§ 751(a)(1) and 751(c)(2) of the Internal Revenue Code, a portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is considered to be attributable to unrealized receivables of LLC.

CONCLUSION

No portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is attributable to the non-P-Cs. However, a portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is considered to be attributable to an interest in the P-Cs, and therefore is attributable to an interest in unrealized receivables. Further, no portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC attributable to the TSA is considered to be attributable to an interest in unrealized receivables. Finally, a portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC may be attributable to the ESA, and thus a portion of such consideration may be attributable to an interest in unrealized receivables as a result of the ESA.

FACTS

Taxpayer is engaged in the business of providing Services as well as other business activities. As of Date 1, Company performed Services in support of its own business activities.

On Date 1, Taxpayer and Company formed LLC as a limited liability company under the laws of State for the purpose of developing the business of providing Services to Company and, potentially, to other customers. In exchange for a capital contribution consisting of cash of \$A and an unsecured and fully available line of credit of \$C, Taxpayer received an interest in LLC consisting of an a% interest in LLC's profits, a b% interest in LLC's capital, and a c% interest in member voting rights in LLC.

Also on Date 1, Taxpayer or its affiliates, Company, and LLC entered into the Agreements. Under the MA, Company agreed to compensate LLC for Services performed by LLC for Company. LLC's compensation under the MA was generally a function of the cost savings that LLC generated for Company by utilizing LLC's personnel and intellectual property to perform Services for Company.

Taxpayer, its affiliates, Company, and LLC intended that LLC would become Company's exclusive provider of Services and intended that Company would reduce the Services it performed internally. In furtherance of this objective, LLC entered into P-Cs with Company and non-P-Cs with third parties to provide Services.

The MA prohibited LLC from assigning its rights under that agreement to another person without Company's consent. The Op Ag provided that neither Taxpayer nor Company was permitted to transfer its membership interest in LLC to a third party.

The Op Ag granted to Company a Call Right to purchase Taxpayer's interest in LLC for its fair market value at any time beginning 15 months after Date 1. Under the Op Ag and the other Agreements, once Company exercised the Call Right, the following consequences were triggered:

- (1) Company would assume 100% voting control of LLC;
- (2) All non-P-Cs would be distributed and assigned to Taxpayer;
- (3) A six-month transition period would begin during which Taxpayer would assist with the transfer of LLC management to Company;
- (4) Taxpayer would be prohibited from hiring any employees of LLC away from LLC unless Company designated them as non-essential;
- (5) All intellectual property that Taxpayer had made available to LLC for the performance of Services for Company would be assigned to Company for Company's use in the performance of Services internally;
- (6) Company would be permitted to purchase from LLC any assets that Company needed to perform Services internally for no more than the book value of those assets; and
- (7) A third-party appraisal would be obtained to determine the fair market value of Taxpayer's interest in LLC. The appraisals would be required to exclude the value of the non-P-Cs in the value of LLC.

On Date 2, Taxpayer, LLC, and Company entered into a TSA, supplementing the other Agreements. The TSA required Taxpayer and LLC to perform Services for Company during a nine-month period following exercise by Company of its Call Right. Under the TSA, the compensation to be paid to LLC and Taxpayer for such Services was limited to the aggregate costs incurred in providing those Services.

On Date 3, Company exercised its Call Right, and the process of transitioning the business of LLC to Company began. As of the time that Company exercised its Call Right, LLC had X employees. LLC, Taxpayer, and Company immediately began to plan and implement the transition of LLC's operations to Company. Pursuant to the TSA, LLC and Taxpayer continued to provide to Company the Services that had previously been provided pursuant to the MA, but received in exchange only payments amounting to the cost of providing such services. Pursuant to the Op Ag, LLC's non-P-Cs were distributed and assigned to Taxpayer on Date 4.

On Date 5, Taxpayer, Company and M, which is wholly owned by Company, entered into C Ag in which the parties specified the services to be provided to Company after the purchase of Taxpayer's interest in LLC. Prior to Date 5, M and Company entered into an ESA to be effective on Date 5 in which M would provide to Company a Y and certain information technology services after the purchase of Taxpayer's interest in LLC in exchange for a flat fee to be paid to Taxpayer or to M, or both. The ESA is not cancelable at will or within a short period of time by Company. Also on Date 5, following the determination of the fair market value of the Taxpayer's interest in LLC, LLC

cancelled an obligation of an affiliate of M in the amount of \$D and Company paid the remaining purchase price of \$E to Taxpayer.

As of the time Taxpayer sold its interest in LLC to Company, the only contract under which LLC rendered Services to another person was the MA, as modified by the TSA, and to a certain extent by the C Ag and the ESA. As of that time, under LLC's accrual method of accounting, LLC had already included in its taxable income all of the income accrued under the MA.

LAW AND ANALYSIS

Section 741 provides that gain or loss recognized by a transferor partner upon the sale or exchange of an interest in a partnership shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in § 751.

Section 751(a) provides that the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to (1) unrealized receivables of the partnership, or (2) inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

Under § 751(b), certain distributions are treated as sales or exchanges. Section 751(b)(1) provides that, to the extent a partner receives in a distribution (A) partnership property which is unrealized receivables, or inventory items which have appreciated substantially in value, in exchange for all or a part of his interest in other partnership property (including money), or (B) partnership property (including money) other than property which is unrealized receivables, or inventory items which have appreciated substantially in value, in exchange for all or a part of his interest in partnership unrealized receivables or substantially appreciated inventory, such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee partner and the partnership (as constituted after the distribution). This provision does not apply to a distribution of property that the distributee contributed to the partnership, or to payments, described in § 736(a), to a retiring partner or successor in interest of a deceased partner.

Section 751(c) provides that the term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered.

Section 751(d) provides that the term "inventory items" means (1) property of the partnership of the kind described in § 1221(a)(1) (stock in trade or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the

close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), (2) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in § 1231, (3) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in § 751(d)(1) or (2).

The legislative history accompanying § 751 provides that the provision was enacted "in order to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70 (1954) (House Report); S. Rep. No. 1622, 83d Cong., 2d Sess. 98 (1954) (Senate Report). Further, § 751(c) was "necessary to prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income." House Report at 71; Senate Report at 99.

Section 1.751-1(a)(1) provides that, to the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under § 741. (Unrealized receivables and substantially appreciated inventory items are in § 1.751-1 referred to as "§ 751 property".)

Section 1.751-1(a)(2) provides that the income or loss realized by a partner upon the sale or exchange of its interest in § 751 property is the amount of income or loss from § 751 property (including any remedial allocations under § 1.704-3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account § 7701(g)) immediately prior to the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to § 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of § 751 and the amount of ordinary income or loss determined under § 1.751-1(a)(2) is the transferor's capital gain or loss on the sale of its partnership interest.

Section 1.751-1(c)(1) provides that the term unrealized receivables, as used in subchapter K, chapter 1 of the Internal Revenue Code, means any rights (contractual or otherwise) to payment for (i) goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or (ii) services rendered or to be rendered, to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or

agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

Prior to December 15, 1999, § 1.751-1(c)(3) provided that, in determining the amount of the sale price attributable to unrealized receivables, or their value in a distribution treated as a sale or exchange, any arm's length agreement between the buyer and the seller, or between the partnership and the distributee partner, will generally establish the amount or value. In the absence of such an agreement, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

Effective December 15, 1999, § 1.751-1(c)(3) provided that, in determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

In T.D. 8847, 1999-52 I.R.B. 701, the Treasury Department and the Service noted the following regarding a potential arm's length agreement between the buyer and the seller to establish the amount of the sale price attributable to unrealized receivables (Allocation Agreements):

One commentator suggested that where a partnership interest is sold or exchanged, the transferor and the transferee of a partnership interest should be permitted jointly to assign values to partnership assets in a written agreement. Because this approach is inconsistent with the hypothetical sale approach of the regulations, this suggestion has not been adopted.

In T.D. 8847, the language in § 1.751-1(c)(3) sanctioning Allocation Agreements was deleted effective December 15, 1999.

In Rev. Rul. 79-51, 1979-1 CB 225, the proceeds received from the sale of a partnership interest attributable to amounts earned or to be earned under a long-term construction contract by a partnership utilizing the completed contract method of accounting were held to be attributable to unrealized receivables.

Payments attributable to a service agreement are attributable to unrealized receivables. In United States v. Woolsey, 326 F.2d 287 (5th Cir. 1963), the portion of the consideration received for the sale of a partnership interest attributable to a contract to manage a mutual insurance company was held to be attributable to an unrealized receivable. In Ledoux v. Commissioner, 77 T.C. 293 (1981), aff'd per curiam, 695 F.2d

1320 (11th Cir. 1983), the Tax Court held that the portion of the taxpayer's gain in excess of the amount attributable to tangible assets was attributable to an unrealized receivable as reflected by a dog track management agreement.

The fact that contract rights are not fixed at the time of the sale of the partnership interest does not prevent the contract rights from being considered as having created an unrealized receivable. Ledoux v. Commissioner, 77 T.C. 293 (1981), *aff'd per curiam*, 695 F.2d 1320 (11th Cir. 1983).

Given that all non-P-Cs were distributed and assigned to Taxpayer prior to the sale of its interest in LLC, under §§ 751(a)(1) and 751(c)(2), no portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is attributable to the non-P-Cs. Thus, because no portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is attributable to the previously assigned non-P-Cs, the non-P-Cs did not cause a portion of such consideration to be considered to be attributable to an interest in unrealized receivables. Further, the Op Ag required that the appraisals exclude the value of the non-P-Cs from the value of LLC, and accordingly from the fair market value of Taxpayer's interest in LLC. Though Allocation Agreements are inconsistent with the hypothetical sale approach promulgated in § 1.751-1(a), the Op Ag provision described is not an Allocation Agreement because it reduces the price paid for the interest in LLC, rather than merely allocating the sale price of the interest among § 751 property and property other than § 751 property. Section 1.751-1(a)(1) provides that money received by a partner in exchange for all or part of his partnership interest shall be considered as an amount realized from the sale of § 751 property "to the extent that money ... received ... is attributable to his share of the value of partnership unrealized receivables." Section 1.751-1(a)(2) provides that the gain or loss realized by a partner upon the sale or exchange of its interest in § 751 property is the amount of income or loss from § 751 property that would have been allocated to the partner "to the extent attributable to the partnership interest sold or exchanged." Given that the non-P-Cs were distributed and assigned prior to the sale of Taxpayer's interest in LLC, and that the Op Ag excluded the non-P-Cs from the fair market value of the partnership interest for purposes of determining the sale price of the partnership interest in LLC, the money received by Taxpayer in exchange for its partnership interest in LLC should not be considered as attributable to the Taxpayer's share of the value of such formerly-held unrealized receivables.

On the other hand, given that all P-Cs remained in LLC prior to the sale of Taxpayer's interest in LLC, a portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is considered to be attributable to an interest in the P-Cs, and therefore is attributable to an interest in unrealized receivables. Given that the proceeds from the sale of the Taxpayer's partnership interest in LLC are attributable in part to the P-Cs, gain or loss realized by the Taxpayer upon the sale of its partnership interest in LLC is attributable in part to the P-Cs (to the extent that the fair market value of the P-Cs differs from the adjusted basis in the P-Cs immediately prior to

the transfer). This result holds regardless of the fact that the P-Cs will terminate once Company becomes both the provider and recipient of Services pursuant to the P-Cs. As the P-Cs are service agreements, proceeds attributable to the P-Cs are attributable to unrealized receivables. The fact that LLC had already included in its taxable income all of the income earned under the MA does not preclude the application of § 751(a) to a portion of the consideration received attributable to an interest in unrealized receivables.

No portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is considered to be attributable to an interest in the TSA, and thus no portion of such consideration is considered to be attributable to an interest in unrealized receivables as a result of the TSA. As the TSA provides for payment only of the costs of Taxpayer to provide Services, the contract provides no profit to Taxpayer, and no portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is considered to be attributable to an interest in the TSA.

Finally, a portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC may be attributable to an interest in the ESA, and thus a portion of such consideration may be attributable to an interest in unrealized receivables as a result of the ESA. As the ESA provides for payment of a fixed fee either to Taxpayer or to M, or to both Taxpayer and to M, to provide a Y and certain services, the contract may provide a profit to Taxpayer. Though the ESA became effective at the time that the Taxpayer sold its interest in LLC to Company, the ESA was entered into prior to the sale, and a portion of the sale price for Taxpayer's interest in LLC may be attributable to the provision of the rights specified in the ESA to Company. Though Taxpayer represented that no part of the sale price of Taxpayer's interest in LLC was attributable to the ESA, the third-party appraisal appears to have included the value of the ESA in the value of the LLC for purposes of determining the sale price of Taxpayer's interest in LLC.

Based on the facts submitted and the representations made, we conclude that, under §§ 751(a)(1) and 751(c)(2), no portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is attributable to the non-P-Cs. Thus, because no portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is attributable to the previously assigned non-P-Cs, the non-P-Cs did not cause a portion of such consideration to be considered to be attributable to an interest in unrealized receivables. On the other hand, given that all P-Cs remained in LLC prior to the sale of Taxpayer's interest in LLC, we conclude that a portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is considered to be attributable to an interest in the P-Cs, and therefore is attributable to an interest in unrealized receivables (to the extent that the fair market value of the P-Cs differs from the adjusted basis in the P-Cs immediately prior to the transfer). Further, we conclude that no portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC attributable to the TSA is considered to be attributable to an interest in unrealized receivables. Finally, we conclude that a portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC may

be attributable to the ESA, and thus a portion of such consideration may be attributable to an interest in unrealized receivables as a result of the ESA.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

With respect to § 751(c), the Taxpayer believes that no portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is considered to be attributable to an interest in the P-Cs, and therefore no portion of this consideration is attributable to an interest in unrealized receivables. Taxpayer believes that the P-Cs had no value because these contracts terminated upon Company becoming the service provider and the service recipient, and because these contracts could not be assigned to a third party. Further, Taxpayer believes that no portion of the consideration received by Taxpayer in exchange for the sale of its interest in LLC is considered to be attributable to the ESA, and thus no portion of such consideration is considered to be attributable to an interest in unrealized receivables as a result of the ESA. Taxpayer believes that no portion of the consideration can be considered to be attributable to the ESA because the ESA became effective at the time that the Taxpayer sold its interest in the LLC to Company, and the Taxpayer represented that no part of the sale price of Taxpayer's interest in LLC was attributable to the ESA.

Our office believes that the Taxpayer's analysis with respect to these points is incorrect. With respect to the P-Cs, we believe that the relevant consideration is the value of the P-Cs immediately prior to the transaction. With respect to the ESA, we believe that the appraisal appears to have included income from the ESA in determining the value of the LLC.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Frank J. Fisher of this office at (202) 622-3050 if you have any further questions.

